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BANKRUPTCY LAW'S LIMITATIONS ON ADVERTISING AND ADVICE TO CLIENTS VIOLATES THE FIRST AMENDMENTS AS APPLIED TO ATTORNEYS

In the case of *Milavetz, Gallop & Milavetz, PA v. United States*, No.05-CV-2626 (D. Minn., Dec. 7, 2006) (J. Rosenbaum), the United States District Court for the District of Minnesota held that provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, regulating bankruptcy attorney's advice to clients and advertising, violates the first amendment's free speech clause.

BAPCPA bars a debt relief agency, a paid provider of bankruptcy assistance, from advising a client "to incur more debt in contemplation" of bankruptcy. This ban is a content based restriction that prevents them from properly advising clients and is not narrowly tailored said Chief Judge James M. Rosenbaum.

BAPCPA requires debt relief agencies to declare in their advertising, "We are a debt relief agency. We help people file for bankruptcy relief under the bankruptcy code." This provision is not narrowly tailored to advance the government's asserted interest in clarifying bankruptcy service ads, Rosenbaum said.

After ruling that those two provisions are unconstitutional as applied to attorneys, the Judge further held that the definition of "Debt Relief Agency" is ambiguous and should not be construed to exclude attorneys to avoid attendant constitutional problems with respect to Bankruptcy Code Sections 526 to 528.

BAPCPA became effective on October 17, 2005. It added Section 101(12A) of the Bankruptcy Code to define a "debt relief agency" as "any person who provides bankruptcy assistance to an assisted person in return for the payment of money or other valuable consideration, or who is a bankruptcy petition preparer under Section 110." Under new Section 526(e)(4), a debt relief agency may not advise a client "to incur more debt in contemplation" of bankruptcy.

CHAPTER 11 ATTORNEYS' FEES NOT SUBJECT TO DISGORGEMENT AFTER CONVERSION TO CHAPTER 7

In the case of *Habbo G. Fokkena v. Fredrikson & Byron, P.A.; Kalina, Wills, Gisvold & Clark, P.L.L.P.; and Merical Assoc., Inc. (In re Hyman Freightways, Inc.)*, No. 06-2607 (D. Minn. Dec. 19, 2006) (J. Magnuson), the Minnesota district court affirmed Judge Kressel's decision which denied a Chapter 7 trustee's motions for refund of professional fees in a converted Chapter 7 case.

In 1997, Hyman Freightways, Inc. filed a Chapter 11 bankruptcy petition. With the bankruptcy court's approval, the debtor hired legal counsel and a financial advisor. A few months after filing, the case was converted to Chapter 7 and counsel and the advisor sought and received bankruptcy court approval for payment of certain professional fees.

Several years later, in preparation for its final report and accounting, the Chapter 7 Trustee sought disgorgement of the fees paid to counsel and the advisor because the estate would be able to pay all Section 503(b) administrative expense claims incurred in Chapter 7, but not all Chapter 11 administrative expenses which were in excess of $3.5 million. The trustee estimated that the distribution to Chapter 11 administrative claimants would be approximately 10%, but if professional fees

were disgorged, claimants would receive approximately 14%.

Judge Kressel denied the motions finding that Section 726(b), while mandating pro rata distribution, does not provide the authority to order disgorgement because it contains no provision for adding property back into the estate. The court also opined that the trustee's argument, carried to its logical conclusion, would require the trustee to recover every payment made during Chapter 11 and redistribute thus unwinding the entire Chapter 11 process.

The court recognized that disgorgement of interim professional compensation was a matter of the bankruptcy court's discretion and that while some circumstances may dictate this result in order to create an equitable result, the bankruptcy court did not abuse its discretion in not ordering disgorgement in this case. Instead, Judge Kressel had properly reexamined the propriety of the fees, weighed the relevant equitable factors, and determined not to require disgorgement.

LENDER'S SECURITY INTEREST DID NOT EXTEND TO DEBTOR'S PARTICIPATION LOANS IN WHICH LENDER WAS A PARTICIPANT

In *ACRO Business Finance Corp. v. M&I Marshall and Isley Bank et. al.*, Adv. Pro. No. 06-04432 (Bankr. D. Minn. Dec. 21, 2006) (J. Kressel) the Bankruptcy Court held loan participations between Debtor and individuals and banks were true sales and not financing arrangements, and the security interests of Debtor's Lender did not extend to the participated loans.

ACRO Business Finance Corp. ("Debtor") is a commercial finance lender specializing in making asset-based loans to small businesses. Debtor is capitalized by, among other loans, a secured line of credit from National City Bank, now known as M&I Marshall and Isley Bank ("Lender"). From its inception, Debtor sold participation interests in its customer loans to banks and individuals.

Lender asserted that the participation agreements between Debtor and the participants were not true loan participations and that its security interest extended to the interests of the participants. As such, Lender claimed all the interest and principal payments collected by Debtor as well as the collateral that secured the loans to the borrowers were subject to Lender's first priority security interest. Debtor commenced a declaratory action seeking a determination that the participations were true participations and not disguised loans, and that Lender's security interest did not extend to the interests of the participants including the underlying collateral.

The Bankruptcy Court applied a four-factored test to determine whether an agreement constitutes a participation: (1) money is advanced by a participant to a lead lender, (2) the participant's right to repayment only arises when the lead lender is paid, (3) only the lead lender can seek legal recourse against the borrower, and (4) the document is evidence of the parties true intentions. The Court found that the participation agreements with the Debtor met each requirement. The Court rejected Lender's argument that the characterization of the participated loans as secured borrowing in the debtor's financial statement indicates that the agreements were loans and not participations.

The Bankruptcy Court also held that Lender's security interest did not extend to the participated loans. The Court found that most of the provisions of the credit agreement leaned toward excluding participants' interests from the security agreement, but there existed conflicting

provisions. To interpret the ambiguous contract, the Court looked to extrinsic evidence. Debtor and the former officer of Lender's predecessor who negotiated the credit agreement testified that there was no intention to include the participated loans as collateral. Moreover, the financing statement excluded the interests of the participants.

DEBT HELD NONDISCHARGEABLE PURSUANT TO 11 U.S.C. §§ 523(a)(2), (a)(4) AND (a)(6).

In *Chicago Title Insurance Company v. David R. Moe (In re David R. Moe),* Bankr. No. 04-32102 (Bankr. D. Minn., Nov. 17, 2006) (J. Kishel), the Bankruptcy Court found $2,286,422.21 plus interest excepted from discharge under §523(a)(2)(A) of which $99,497.60 was also excepted under §523(a)(4) and §523(a)(6). The Plaintiff's business includes the issuance of title insurance in connection with residential real estate sales. Old Dominion Title Services ("Old Dominion") later known as Profile Title & Escrow Corporation ("Profile") became an agent of the Plaintiff for sale of title insurance under the Issuing Agency Contract ("IAC") entered in July 1999. The Defendant was the President and 50% shareholder of Old Dominion and personally guaranteed Old Dominion's performance under the IAC. In November of 2001, Defendant attempted to enter into a Stock Purchase Agreement ("SPA") to transfer his full shareholding in Old Dominion. The Plaintiff acquired a money judgment in District Court for $2,286,422.21 plus interest to cover the $1,921,072.62 it paid to satisfy claims made on title insurance policies that it had issued on real estate transactions handled by Old Dominion / Profile.

The first preliminary issue was whether the Defendant is liable to the Plaintiff on account of this debt. The Court found that, because a corporate principal's personal guaranty of the corporation's obligation remains enforceable despite the termination or alteration of that person's formal legal affiliation with the corporation, Defendant is liable for all debt Plaintiff accrued while Old Dominion was responsible for agency performance under the IAC. The second preliminary issue was for how long the Plaintiff remained responsible. The Court found that even if the SPA transfer was relevant, there was no evidence that the sale was ever consummated. Thus, the Court concluded Defendant was liable for the entire accrual of debt that was reduced to judgment.

The Plaintiff sought to have the Defendant's debt to it excepted from discharge under three different theories. The first under §523(a)(2)(A), which creates an exception to discharge for debts that were incurred through false pretenses, false representation or actual fraud. The Court found that Defendant had an obligation to disclose the funding difficulties it had while acting as an agent for Old Republic; another issuer of title insurance. The Court concluded that Defendant's failure to disclose this demonstrated the intended inducement of Old Dominion to commit to the Plaintiff as insurer to future clients which led directly to the losses that the Plaintiff eventually suffered. The Court thus held that the whole of Old Dominion's debt to Plaintiff is traceable in causation back to the Defendant's act of false pretense and thus the Defendant's liability to the Plaintiff is excepted from discharge under §523(a)(2)(A).

Second, Plaintiff sought to have the debt excepted from discharge under §523(a)(4), where such is possible if the debt arose from fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny. The Court found Old Dominion, the corporation, was the only participant

with fiduciary status as an agent. Thus, Defendant's individual liability is only contractual as guarantor and arose only after Old Dominion failed to make good to the Plaintiff on any debt which Old Dominion became subrogated. Thus, Defendant's debt to Plaintiff was not excepted from discharge as one for fraud or defalcation while acting in a fiduciary capacity. However, Defendant knowingly received $99,497 drawn on client escrow accounts maintained under the name of Old Dominion or Integrity. The Court concluded that the misappropriation of this sum was separately excepted from discharge under larceny.

Plaintiff also plead §523(a)(6), which excepts from discharge any debt for willful and malicious injury by the debtor to another entity or to its property and can include willful and malicious conversion. The Court found that Defendant knew both that he was invading the legal interests of those with proper claims to the funds, and that his receipt and use of the funds would deprive the proper owners of the value of them. The Court concluded that under conversion, Defendant's intent to bring both of those consequences also resulted in the exception to discharge of the $99,497 under §523(a)(6).

WHETHER DEBTOR RECEIVED SUFFICIENT NOTICE OF A MOTION AND EXPEDITED HEARING DEPENDS UPON THE PARTICULAR CIRCUMSTANCES OF THE CASE

In *Alvin Leroy Baldwin v. Credit Based Asset Servicing and Securitization (In re: Alvin Leroy Baldwin)*, No. 06-6027EM (B.A.P. 8th Cir. 2006) (J. Federman) the B.A.P. affirmed the Bankruptcy Court's order dismissing the debtor's eighth Chapter 13 bankruptcy case.

Since 1996 the debtor had filed eight Chapter 13 bankruptcy cases, all of which were dismissed prior to confirmation. Four of the eight cases were filed after the debtor obtained a home loan with the predecessor of Credit Based Asset Servicing and Securitization ("CBASS") in May 2002.

Upon receiving notice of the eighth Chapter 13 filing, CBASS postponed its scheduled foreclosure sale. On March 3, 2006 CBASS filed a Motion to Expedite Hearing and Motion to Dismiss, or in the Alternative, for Relief from the Automatic Stay. CBASS also requested that the debtor be barred from filing another case for 180 days.

The debtor did not appear at the hearing and the Bankruptcy Court granted the motion to expedite, dismissed the case and barred the debtor from refiling for 180 days. On March 23, 2006 the debtor filed a motion asserting that he did not receive sufficient notice of CBASS' March 3 motion because he is an over-the-road truck driver and was on the road at the time the March 3 motion was filed and served. The debtor requested that his case be reinstated and the foreclosure be set aside as void. The debtor also filed a Notice of Appeal on April 3, 2006.

The debtor's April 3rd appeal of the Order dismissing the case as being filed in bad faith was not timely, and was therefore not considered by B.A.P. However, the B.A.P. characterized the March 23rd Motion by the debtor as Rule 60(b) motion to vacate the dismissal Order, and as such, the motion was timely. Pursuant to the March 23rd Motion, the sole issue considered by the B.A.P. was whether the Bankruptcy Court erred in failing to set aside the Order dismissing the debtor's case due to insufficiency of the notice of CBASS's Motion and hearing.

CBASS filed its Motion on Friday, March 3, 2006 and the hearing was set for

March 9, 2006. CBASS mailed the Motion and notice to the debtor on March 3, 2006. The debtor asserted that first-class mail notice, mailed six days prior to the hearing was insufficient. The B.A.P., however, pointed out that the issue is not whether the debtor had a certain number of days to respond, but whether the notice of the Motion and hearing was reasonable under the particular circumstances.

The Local Rules for the Bankruptcy Court in the Eastern District of Missouri require, similarly to Minnesota, that the motion and notice of hearing for a motion to be heard on an expedited or emergency basis be served as expeditiously as possible. The B.A.P. noted that under other circumstances, a Motion and notice of hearing mailed six days prior to the hearing date might not be sufficient. However, in this case, the debtor filed bankruptcy when he knew a foreclosure sale was pending and during a time when he was going to be absent from the State of Missouri for several weeks. In addition, he also filed *pro se*, such that CBASS could not contact an attorney for the debtor to provide notice of the Motion and hearing.

The B.A.P. held that under the particular circumstance of this case, CBASS's attempt to effect service by first-class mail and personal service was sufficient notice of the hearing under the requirements of the Bankruptcy Code and Local Rules, and was also sufficient to adequately protect debtor's constitutional due process rights.

8TH CIR. B.A.P. AFFIRMS BANKRUPTCY COURT'S DENIAL OF FARMERS' CHAPTER 12 PLAN AND DISMISSAL OF THE CASE

In *Rice v. Dumbar (In re Rice)* No. 06-6045SI (B.A.P. 8th Cir., Dec. 11, 2006) (J. Kressel) the B.A.P. affirmed the Bankruptcy Court's order denying confirmation of the debtors' Chapter 12 plan.

The debtors are farmers from Iowa. They owned an 120 acre farm and used the farm to secure loans from Commerce Bank of Geneva, Minnesota and the FSA. The debtors owed Commerce Bank $182,000 that was secured with a first priority lien on 40 acres of the farm and a second priority lien on 80 acres of the farm. After failing to make payments since November of 2002, Commerce Bank commenced a foreclosure by action lawsuit in the Iowa District Court, which was granted on January 28, 2005. The debtors further delayed the foreclosure by appealing the Iowa District Court's decision to the Court of Appeals and the Iowa Supreme Court.

On October 14, 2005, the debtors filed a voluntary Chapter 12 bankruptcy case to prevent Commerce Bank from foreclosing on their farm property. The debtors proposed a plan in January of 2006 that was rejected the creditors and the Bankruptcy Court. The Bankruptcy Court ordered the debtors to re-file a plan no later than June 6, 2006 and directed the debtors to amended the plan to contain (1) a detailed liquidation analysis, (2) cash flows for the past two years and the current year to date cash flow, and (3) projection for the rest of the year and the next three years.

The debtors proposed an amended Chapter 12 plan, however the Bankruptcy Court found that the amended plan did not satisfy 11 U.S.C. § 1225(a) as they could not satisfy the feasibility test nor the best interest of the creditors test.

The B.A.P. found that the Bankruptcy Court did not abuse its discretion by denying the confirmation of the debtors' Chapter 12 plan. The Bankruptcy Court had found that a

liquidation of the 120 acre farm would net enough money to pay all of the debtors' creditors in full. Therefore, in order to satisfy 11 U.S.C. § 1225(a)(4), which requires creditors to receive more than they otherwise would in a Chapter 7 liquidation setting, the debtors' would need to pay their creditors interest on their claims. Because the debtors proposed to pay their creditors no interest, the B.A.P. held that the Bankruptcy Court was perfectly within its right to made the determination that the amended Chapter 12 plan did not satisfy the best interest of the creditors test. Furthermore, the Bankruptcy Court determined that the debtors' Chapter 12 plan payments were not feasible because the plan payments would require the debtors to receive two years worth of income in order to make the proposed plan payments. Because the debtors could not demonstrate that they could make all the plan payments pursuant to 11 U.S.C. § 1225(a)(6), the B.A.P. affirmed the Bankruptcy Court's determination that the debtors' plan was not feasible.

The B.A.P. concluded that despite having numerous chances to propose a Chapter 12 plan and 8 months of time in which to confirm a Chapter 12 plan, it was not an abuse of discretion for the Bankruptcy Court to dismiss the debtors' Chapter 12 case.